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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of Sections of)
The Cable Television Consumer)
Protection and Competition Act)
of 1992)

Rate Regulation)

MM Docket No. 93-215

REPLY COMMENTS OF ~~CONCERN~~ CABLE COMMUNICATIONS, INC.

Brenda L. Fox
Leonard J. Kennedy
Jane E. Jackson

Dow, Lohnes & Albertson
1255 Twenty-Third Street, N.W.
Suite 500
Washington, D.C. 20037
(202) 857-2500

September 14, 1993

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REPLY COMMENTS

Comcast Cable Communications, Inc., a subsidiary of Comcast Corporation, ("Comcast"), by its attorneys, hereby submits its reply comments in the above captioned proceeding.^{1/} In this reply, Comcast responds to the so-called "regulatory parity" argument put forth in the joint comments of Bell Atlantic, NYNEX, and Pacific.^{2/} Comcast also challenges the cost of capital testimony appended to the Joint Telco comments.^{3/}

I. INTRODUCTION.

In the NPRM the Commission proposed traditional public utility rules to govern cost-of-service showings by cable operators seeking to justify rates above initially-

1/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Notice of Proposed Rulemaking, MM Dkt. 93-215, FCC 93-353 (released July 16, 1993) ("NPRM").

2/ Comments of Bell Atlantic, et al. at 4-9 (hereinafter "Joint Telco Comments").

3/ See Affidavit of James H. Vander Weide.

permitted rates. Comcast and other parties have demonstrated that these traditional approaches, although well-tested in the public utility context, would produce unconstitutional results if applied to the cable telephone industry.^{4/} Rates established using a utility-style original cost ratebase would reflect an unjust balance of consumer and investor interests and would thus be confiscatory.^{5/} A cable operator would not be able to "operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed"^{6/} because its investors would have been deprived of a recovery of and return on substantial sums of capital legitimately invested in cable television systems.

In its comments, Comcast outlined a constructive proposal for a transitional ratemaking methodology that avoids these constitutional pitfalls.^{7/} The Joint Telco

4/ Comments of Comcast at 4-17; see Comments of CVI at 22; Comments of Viacom at 26; Comments of Cablevision Systems at 22; Comments of Continental Cablevision at 52.

5/ See F.P.C. v. Hope Natural Gas, 320 U.S. 591, 602 (1944); see also, Washington Gas Light v. Baker, 188 F.2d 11, 14 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951).

6/ Hope, 320 U.S. at 605.

7/ Comments of Comcast at 23-37. Numerous commenters advocate the need for a transition period to allow the cable industry to make a smooth adjustment to a regulated environment. See, e.g., Comments of Viacom at 12; Comments of Prime Cable, et al. at 25; Comments of Tele-Media Corporation at 5; Comments of Cable Operators and

(continued...)

Parties, by contrast, put forth the destructive and cynical notion that "regulatory parity" between telephone and cable is the most important goal of this proceeding. They also submitted cost of capital testimony prepared by Dr. James H. Vander Weide advocating a blatantly confiscatory rate of return well below the lower end of the inadequate range of returns proposed in the NPRM. For the reasons set out below and in the attached affidavit of Dr. George Schink, the Commission should reject the arguments of the Joint Telco Parties.

II. THE "REGULATORY PARITY" CONCEPT ESPOUSED BY THE JOINT TELCOS IS CYNICALLY SUPERFICIAL, FUNDAMENTALLY FLAWED, AND MUST BE REJECTED.

The Joint Telco parties contend that the Commission's "guiding principle in this proceeding should be regulatory parity" between the telephone and cable industries.^{8/} They define "regulatory parity" as the application of identical ratemaking methodologies to the two industries. This elevation of what is at most superficial similarity to the level of a guiding principle is patent nonsense and must be rejected. The guiding principle in this proceeding is the Constitutional principle that

^{7/} (...continued)
Associations at 15; Comments of Cablevision Systems at 35;
Comments of Continental Cablevision at 14; Comments of
California Cable Television Association at 75.

^{8/} Joint Telco Comments at 1.

generally governs ratemaking proceedings: the end results of ratemaking must be non-confiscatory, reflecting a just and reasonable balance of investor and consumer interests.^{9/} That balance can only be achieved here through careful attention to the facts and particular circumstances at hand; it will never be achieved by importing a scheme developed in another era^{10/} for another industry.

Comcast does not dispute the notion that regulatory policies should treat competitors fairly. Comcast does submit that the Joint Telco parties have their analysis exactly backwards. Applying identical ratemaking schemes to differently situated industries is a prescription for regulatory disparity. In particular, applying identical ratebase rules to cable and telephone would place a severe regulatory handicap on the cable industry, hindering development of competition and potentially driving some cable systems out of business altogether.

^{9/} Hope, 320 U.S. at 602; Washington Gas Light, 188 F.2d at 14.

^{10/} The Joint Telco Parties state their belief that much of telephone regulation is outmoded, yet insist that similar rules must be adopted for cable. Joint Telco Comments at 2. Far from producing administrative convenience, as they suggest, it would be a grotesque waste of administrative resources for the Commission to purposely impose a purportedly outmoded scheme on the cable industry simply because it is used for the telephone industry.

Traditional utilities have been subject to pervasive regulation for as long as investors can remember. The Commission's net original cost ratebase rules for telephone companies are fair for them because they are built into investors' expectations about the risks and rewards of investing in those companies. Those same rules would radically frustrate the expectations of cable investors, who until recently had no reason to believe their returns would be subject to such severe regulatory limitations.^{11/} To adopt such rules in the name of "regulatory parity" would be a travesty.

Instead, the Commission should adopt the transitional ratebase methodology outlined in Comcast's comments.^{12/} This methodology strikes the constitutionally essential balance between the interests of consumers and investors, allows investors to eventually achieve a recovery of and return on all of their investment, and in no way grants cable any advantage over the telephone industry or any other competitors.

The Joint Telcos also advocate that the Commission take the time now to develop accounting, cost allocation, and depreciation rules that "scrupulously track" those that apply to telephone. The Commission must not be distracted

^{11/} See Comments of Comcast at 23-37.

^{12/} Id.

by these demands from the critical task at hand, which is to develop a set of rules under which cable systems can justify their initial rates. Comcast submits that long-term issues can and should be deferred to another phase of this proceeding.

III. THE TESTIMONY OF DR. VANDER WEIDE MUST BE GIVEN NO WEIGHT IN DETERMINING EITHER A UNITARY RATE OF RETURN FOR THE CABLE INDUSTRY OR AN ALLOWED RETURN FOR ANY CABLE OPERATOR.

A. Dr. Vander Weide's analysis of the cost of capital of the cable industry must be disregarded because it is based on unsupported assumptions.

Vander Weide contends that the capital attraction standard requires determination of an average cost of capital for the cable industry using the cable industry's own average actual capital structure.^{13/} He then purports to compute this average actual capital structure using data from six cable operators representing about 30% of all cable subscribers and finds it to be 113.77% debt. Observing this to be an answer that cannot be used in his formula, he subtracts accumulated losses from equity and arrives at an actual average debt ratio of 86%. He accepts this figure as typical for the industry and as "more likely to approximate the industry's long-run target capital structure."^{14/}

^{13/} Affidavit of James H. Vander Weide at 4. As explained in the attached affidavit of Dr. Schink, the capital attraction standard cannot be so narrowly construed.

^{14/} Id. at 6-7.

There is no reason to believe that this 86% debt/14% equity capital structure is appropriate for use in determining the cost of capital for any cable operator. Vander Weide justifies his approach primarily on the grounds that it mimics the approach used by the Commission in determining the unitary rate of return for interstate access services.^{15/}

Crucial factors that made this "actual average" method acceptable for the telephone industry are, however, not present in the case of cable. The seven large companies (the Regional Bell Holding Companies) used to compute the average capital structure of the interstate access industry represented about 80% of the entire industry, not a mere 30%. Moreover, the companies chosen were, at the time the Part 65 rules were adopted, quite similar to one another in structure and operations, and displayed only a narrow range of debt/equity ratios.^{16/} By contrast, large cable companies show an extremely wide range of capital

^{15/} See 47 C.F.R. § 65.304.

^{16/} See Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Phase II, 51 Fed. Reg. 1795 (Jan. 15, 1986), recon. 104 FCC 2d 1404 (1986); Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Phase III, 51 Fed. Reg. 32920 (Sept. 17, 1986), recon. denied 2 FCC Rcd 5636 (1987).

structures.^{17/} Dr. Vander Weide's analysis also utterly ignores the realities of the capital markets, which would hardly tolerate the capital structure he proposes as a long-term goal for an industry subject to the business and regulatory risks facing the cable industry. Vander Weide's average capital structure simply has no claim to being the actual capital structure of the cable industry. There is no evidence whatever that it represents the long-term target capital structure for the industry.^{18/}

B. Dr. Vander Weide's testimony must be disregarded because it produces a confiscatory end result.

Comcast does not believe that this proceeding will produce a sufficient record upon which to base prescription of a unitary rate of return for the entire cable industry. However, if the Commission does decide to prescribe a rate of return, it should accord no weight whatsoever to Dr. Vander Weide's testimony. While paying lip service to the capital attraction standard, he recommends a shockingly low 8.83% rate of return. As explained in the attached

^{17/} See Comments of Comcast, attachment, at 9 (showing equity to asset ratios for twelve cable companies ranging from 59.8% equity to -99.9% equity).

^{18/} Comcast continues to believe that the Commission should not attempt to promulgate a unitary rate of return for the cable industry. Comments of Comcast at 37-40. However, if the Commission is determined to do so, it can avoid these thorny capital structure issues by directly estimating the required pre-tax overall return, as suggested by AUS Consultants. See Id., attachment.

affidavit of Dr. Schink, setting the rate of return at this level would destroy the value of current cable equity holdings and cripple the industry's ability to attract equity capital in the future. Thus, even if the logic behind Vander Weide's analysis were unassailable, the Commission would be compelled to reject it.

IV. CONCLUSION.

Comcast submits that the Commission must concentrate its efforts in this proceeding on adopting a fair and balanced transitional ratemaking methodology for systems that must justify their initial rates. The most critical feature of that methodology must be a ratebase mechanism for assuring that cable investors are allowed the opportunity to recover their entire investment, including amounts invested in intangible assets.

The Commission must reject the unwarranted demands of some telephone companies that the Commission immediately impose the panoply of traditional public utility regulation on the cable industry in the name of "regulatory parity."

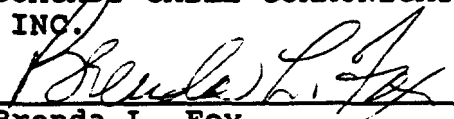
The Commission should accord no weight whatever to the cost of capital testimony submitted by the Joint Telco

Parties. That testimony is based on unfounded assumptions and reaches a confiscatory end result.

Respectfully submitted,

COMCAST CABLE COMMUNICATIONS,
INC.

By:


Brenda L. Fox
Leonard J. Kennedy
Jane E. Jackson

Its Attorneys

DOW, LOHNES & ALBERTSON
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of the Cable Television)
Consumer Protection and)
Competition Act of)
1992 Rates Regulation)

AFFIDAVIT OF GEORGE R. SCHINK

George R. Schink deposes and says:

1. I am Chairman and CEO of the AUS Consultants, Industry Analysis Group. My business address is AUS Consultants, Industry Analysis Group, 200 Four Falls Corporate Center, Suite 308, West Conshohocken, Pennsylvania 19428. My experience involves a broad range of economic analyses of market structure and dynamics in several industries. In addition, I have presented testimony in numerous proceedings before state and Federal regulatory agencies, in state and Federal courts, and before Congress.

2. I was awarded a B.S. in Economics from the University of Wisconsin at Madison in 1964, and a Ph.D. in Economics at the University of Pennsylvania in 1971. I was a lecturer in the Department of Economics at the University of Maryland from 1968 through 1972, where I taught various courses in economics, mathematics and econometrics. I also served as a visiting lecturer on economics at the University of Pennsylvania in 1973. I was also Research Fellow of the University of Pennsylvania's Economic Research Unit on behalf of Lawrence R. Klein (1965-1968), and the

Resident Principal Investigator for the Quarterly Model Project of the Brookings Institution (1969-1972).

3. From 1972 through 1988, I held a number of positions with The WEFA Group (formerly Wharton Econometric Forecasting Associates) in Bala Cynwyd, Pennsylvania, including Executive Director of Special Projects, Executive Director of the Wharton Annual Model Project, Vice President of the U.S. Modeling Services, Senior Vice President of Consulting Services, and Vice President of Research and Development. I assumed my current position as Chairman and Chief Executive Officer of AUS Consultants, Industry Analysis Group in June of 1988.

4. I have included in my resume, which is attached as Appendix 1, a list of my appearances as an expert witness together with a list of my pertinent research publications.

A. Introduction and Summary

5. I have been asked to review and critique the comments of Dr. James H. Vander Weide whose affidavit is attached to the Joint Comments of Bell Atlantic, The NYNEX Telephone Companies, and the Pacific Companies (MM Docket No. 93-215, August 25, 1993) hereinafter referred to as the Vander Weide Affidavit or the Affidavit. My comments will focus on Dr. Vander Weide's proposals regarding determining required revenues for cable television companies (i.e., his discussion of the fair rate of return and of the rate base). I, with Frank J. Hanley, have previously submitted rate of return and rate base definition recommendations for the

cable television industry.¹ To keep these reply comments as brief as possible, I will refer to these previously submitted recommendations as appropriate instead of reiterating points that already have been made.

6. Dr. Vander Weide incorrectly asserts (Affidavit at ¶18, pp. 11-12) that the cable industry is less risky than the telephone industry. As will be demonstrated below, the cable industry is much riskier than the telecommunications industry and also much riskier than the S&P Industrials.

7. Dr. Vander Weide recommends that the Commission employ a capital structure for the cable television industry with 86 percent debt and 14 percent equity (Affidavit at ¶10, pp. 6-7). This capital structure is arrived at by arbitrarily eliminating accumulated losses from the definition of equity for the cable industry because the six cable companies evaluated by Dr. Vander Weide had a debt ratio of 113.77 percent (i.e., these companies had negative equity). Without any supporting data or arguments, Dr. Vander Weide improperly asserts that an 86 percent debt ratio is likely to approximate the cable television industry's long-run target capital structure.

8. Given the high risk of the cable industry, the 50/50 capital structure proposed by the Commission is conservative. As the Commission knows, the telephone industry companies sponsoring

¹See George R. Schink and Frank J. Hanley, "Rate of Return Recommendations for the U.S. Cable Television Industry," August 25, 1993, Submitted as an attachment to Comments of Comcast Cable Communications, Inc. (hereinafter Rate of Return Recommendations).

Dr. Vander Weide's affidavit have justified correctly a higher equity ratio (approximately 60 percent) than electric or gas distribution companies (whose equity ratios typically fall in the 40 to 50 percent range) because the telephone industry is riskier than the electric or gas distribution industries. Given that the cable television industry is riskier than the telecommunications industry, the long-run target capital structure for cable television industry could be higher than that for the telecommunications industry (i.e., higher than 60 percent).

9. In arriving at his recommended overall after-tax return for the cable television industry of 8.83 percent (Affidavit at ¶23, p. 14), Dr. Vander Weide does not properly take into account the effect that his 86 percent debt/14 percent equity capital structure would have on the cost of common equity. Dr. Vander Weide uses a cost of common equity capital for the S&P Industrials whose common equity ratio is close to 60 percent. The cost of common equity for a company with a common equity ratio of 60 percent is much lower than that for a company with a 14 percent common equity ratio. However, Dr. Vander Weide failed to adjust the S&P Industrials' cost of capital upward to reflect his assumed very low common equity ratio for the cable television industry. While I believe that the 50/50 ratio suggested by the Commission could be an appropriate ratio to apply to the cable television industry, if Dr. Vander Weide's capital structure were used, then the cost of common equity would have to reflect this low common equity ratio. I present a method below for adjusting the equity

ratio. A proper adjustment produces a result that is near the upper end of the 10 to 14 percent after-tax return range recommended by the Commission instead of being substantially below this range as suggested by Dr. Vander Weide.²

10. Dr. Vander Weide advocates that the rate base be limited to the net original cost of tangible assets. I previously recommended that the initial rate base be defined as the value of invested capital on the books of the cable companies with a transition to an original cost rate base over a ten-year period.³ Given that cable systems were sold in the late 1980s at multiples of ten times book value⁴ (which is consistent with the multiples being paid for other companies at that time)⁵, Dr. Vander Weide's proposed definition of the rate base could exclude 90 percent of the invested capital for such cable systems. Contrary to Dr. Vander Weide's unsupported assertion, expected monopoly profits are

²In Rate of Return Recommendations, the recommended pre-tax overall rate of return was 18.9 percent. Assuming an 8 percent debt cost, a business (corporate) income tax rate of 40 percent, and a 50/50 capital structure, the corresponding after-tax overall cost of capital would be 12.9 percent. Such a return would not, however, suffice to maintain the financial viability of a cable company unless it were applied to a ratebase that included all of the capital invested in the business, and not only to the original cost of tangible assets. See E., below.

³George R. Schink, Joseph F. Brennan, and Frank J. Hanley, "White Paper on Recommended Regulation for the U.S. Cable Television Industry," August 25, 1993, submitted as Exhibit 12 to the Comments by Cable Operators and Associations (hereinafter referred to as the White Paper), see pp. 33-47.

⁴Some systems were sold at higher multiples but were not as high as the multiples paid for other industries.

⁵White Paper, pp. 27-29.

not required to produce market prices for firms above the net original cost of tangible assets.⁶

11. Finally, Dr. Vander Weide presents a much too narrow interpretation of the capital attraction standard (Affidavit at ¶18, p. 5). Dr. Vander Weide appears to imply that one need evaluate only the cost of capital (i.e., the allowed rate of return) and not the dollar revenue requirements implied by that rate of return and the rate base relative to the dollars required to meet a company's debt obligations. Revenue requirement dollars are used to pay interest, pay income taxes, and provide a return on equity capital.

12. One key element of the capital attraction standard is that sufficient funds be generated to not just meet interest payments but to provide some security to the holders of the debt instruments that the interest payments can be made in the event of a short-term business reversal (e.g., a short-term drop in revenues). Such security is provided if pre-tax income is sufficient to cover interest more than one time (e.g., 1.5 times, 2.5 times, or even 3.5 to 4.0 times). Therefore, the Commission should adopt minimum pre-tax interest coverage standards for the cable television industry to satisfy the capital attraction standard.

⁶White Paper, pp. 33-35.

B. The Cable Television Industry is Riskier Than the Telecommunications Industry and A Typical S&P Industrial Company

13. Dr. Vander Weide makes a general statement that the telecommunications and cable industries are "rapidly converging" (Affidavit at ¶5, p. 3). While the two industries currently compete in some markets and this competition is expected to intensify, the two industries are and will remain quite different.

14. The telecommunications industry is properly perceived by the financial community as having a much lower business risk than the cable industry. Telecommunications companies have essentially 100 percent of the market in the areas they serve while cable television companies typically have a much lower percentage. Telephone companies are much larger than the typical cable company implying that the market will assign a higher risk to the earnings of the cable companies. Telephone companies are old established firms with a long track record of profitability while the cable industry is relatively new and has no track record of profitability. Telephone companies offer a service which is viewed as a virtual necessity with no direct competition (i.e., local loop telephone service) while cable television provides a discretionary service in competition with the services provided by a broad array of entertainment industry companies (movies, television, radio, video retailers, video games, publishers, etc.).

15. Dr. Vander Weide's Affidavit is sponsored by three of the seven RHCs. As a result, I have assumed that Dr. Vander Weide's comments regarding the convergence of the telecommunications and

cable industries at least includes the seven RHCs. Dr. Vander Weide considers six U.S. cable companies as follows:

- Cablevision Systems (Cablevision);
- Comcast Corporation (Comcast);
- Tele-Communications, Inc. (TCI);
- Adelphia Communications (Adelphia);
- Cablevision Industries (CI); and
- Continental Cablevision (Continental).

The cable company group was limited to these six companies by Dr. Vander Weide because Compustat provides financial data only for these six cable companies. Value Line evaluates the first three of these companies. Therefore, in comparing the cable companies to the seven RHCs, I have focused on Cablevision, Comcast, and TCI. These three cable companies provide a "close to pure-play" investment in the cable television system business (i.e., the business being subjected to regulation). Appendix 2 contains the most recent Value Line analyses of the three cable companies. TCI is the largest operator of cable television systems in the nation with 10.2 million basic subscribers, and cable television subscriber charges provide most of TCI's revenues. Comcast is a major cable television system operator with 2.6 million subscribers. In 1992, cable television systems provided 81 percent of Comcast's revenues. Cablevision Systems Corporation serves

approximately 2.1 million subscribers and revenues from these subscribers constitute a large percentage of their revenues.⁷

16. Appendix 3 presents the most recent Value Line analyses for the seven RHCs. Appendix 4 compares the size (measured by 1992 revenues) and the financial health (measured by 1992 net profits and the 1992 common equity ratio) of the seven RHCs and the three "close to pure-play" cable companies. Average 1992 revenues for the seven RHCs was \$11.770 billion while average 1992 revenues for the cable companies were \$1.682 billion. Net profits in 1992 for the seven RHCs averaged \$1.331 billion versus an average loss of \$163 million for the three cable companies. The common equity ratio for the seven RHCs was 59.0 percent while the average common equity ratio⁸ for the three cable companies was negative. Clearly, the seven RHCs are much larger and much healthier financially than are the three cable companies.

17. Within a given industry, smaller sized companies are considered riskier and have higher costs of capital than do large firms in the same industry. Further, smaller companies in general are considered riskier than larger companies and have a higher cost of capital. This result has been documented extensively in the

⁷Analysis of the results presented by Value Line suggests at least 80 percent and possibly well over 90 percent of their revenues come from their cable television systems' subscribers.

⁸For the three cable companies, this ratio was approximated by the 1992 ratio of net worth to net worth and long-term debt.

financial literature.⁹ Therefore, on the basis of size alone, the cable system companies should have a higher cost of capital.

18. Appendix 5 presents the Value Line analyses for five independent telephone companies. The last two companies presented in Appendix 5, GTE and Sprint, are large diversified companies. GTE is essentially like the seven RHCs (in fact, GTE's 1992 revenues of \$19.984 billion make it larger than any of the seven RHCs). Sprint, while as large as the smaller RHCs, is primarily in the long-distance business (in 1992, long-distance revenues accounted for 61 percent of Sprint's total revenues while local telephone revenues account for 32 percent of total revenues). Therefore, Sprint will be seen as riskier because of its heavy involvement in the very competitive long-distance market. Finally, the third company, Citizens, in 1992 obtained 67 percent of its revenues from the relatively low-risk electric, water, and gas distribution utility businesses and 33 percent from the local

⁹The fact that risk and the cost of capital rises as firm size declines is discussed and empirically validated in Eugene F. Fama and Kenneth R. French, "Common Risk Factors in the Returns on Bonds and Stocks," Working Paper, Graduate School of Business, University of Chicago, July 1992, Eugene F. Fama and Kenneth R. French, "The Economic Fundamentals of Size and Book-To-Market Equity," Working Paper, Graduate School of Business, University of Chicago, March 1992, and Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns," Journal of Finance, June 1992, pp. 427-465. This relationship also has been documented by Rolf W. Banz, "The Relationship Between Return and Market Value of Common Stocks," Journal of Financial Economics, 1981, 9, pp. 3-18, Sanjoy Basu, "The Relationship Between Earnings' Yield, Market Value and Return for NYSE Common Stocks," Journal of Financial Economics, 1983, 12, pp. 129-156, and Donald B. Keim, "Stock Market Regularities: A Synthesis of the Evidence and Explanations" in Elroy Dimson, ed. Stock Market Anomalies, Cambridge University Press, 1988.

telephone business. While the first two companies, ALLTEL and Century Telephone, are diversified, their primary business is the local telephone business. In 1992, the telephone division of ALLTEL generated 71 percent of operating income, and the telephone division of Century generated 83 percent of revenues.

19. Therefore, ALLTEL and Century can be used to illustrate that smaller companies are perceived as being riskier than larger companies in the same industry. The financial risk of ALLTEL and Century Telephone is similar to that of the seven RHCs because the two smaller companies have a similar common equity ratio to those of the RHCs. ALLTEL has a 1992 common equity ratio of 55.8 percent while Century Telephone has a 1992 common equity ratio of 49.5 percent.

20. Appendix 6 compares the Value Line betas and financial strength ratings of the seven RHCs, the three cable companies, and the two small telephone companies. The average beta for the seven RHCs is 0.86 which is less than the market average of 1.0. The average beta for the S&P Industrials is very close to 1.0. Therefore, on the basis of beta, the seven RHCs are less risky than the S&P Industrials. Turning to the third page of Appendix 5, the average beta for the two small telephone companies is 1.10 indicating that smaller companies in a given industry are viewed as riskier than larger companies. The size of these two telephone companies is similar to the average size of the three cable companies; the average 1992 revenues for the three cable companies

was \$1.7 billion while the average 1992 revenue for the two independent telephone companies was \$1.2 billion.

21. The average Value Line beta for the three cable companies is 1.57 which is substantially larger than the betas for the two independent telephone companies, the S&P Industrials, and the seven RHCs. This indicates that the market perceives the risk of investing in the cable companies as being much higher than the risk of investing in the telephone companies or in the S&P Industrials. Therefore, the market will demand a substantially higher cost of equity capital from the three cable companies.

22. The seven RHCs are extremely highly rated on all of Value Line's financial measures. Their safety and financial strength is assigned the highest possible ranking. Stock price stability and earnings predictability also are very high. Investing in the seven RHCs is viewed by Value Line as being very safe, stable and predictable and the companies are all very strong financially. Value Line's portrayal of the three cable companies is almost at the opposite end of the spectrum. Safety is below average, financial strength is low, stock price stability is low, and earnings predictability is low. The Value Line financial strength rating is similar to the S&P and Moody bond ratings. A "B-" rating is below investment grade which is consistent with the grading of the debt instruments of these companies by S&P and Moody's.

23. Appendix 7 provides a five-year historical perspective on the common equity ratio, the pre-tax interest coverage, and the return on average common equity for the seven RHCs, the two

independent telephone companies, the S&P Industrials, and the three cable companies. Over the 1988-92 period, the seven RHCs all had common equity ratios above 50 percent and the average ratio across all seven companies was 59 percent. The two independent telephone companies also has common equity ratios above 50 percent and the ratio for the two companies averaged 53 percent. Finally, the S&P Industrials had a common equity ratio of 56 percent. None of these companies or group of companies was highly leveraged. The three cable companies were all highly leveraged with the highest individual company common equity ratio being 18.5 percent (for TCI).

24. Similarly, the pre-tax interest coverage ratios for the seven RHCs, the two independents, and the S&P Industrials are all above 3.0 with the two telephone company groups having average ratios above 3.8. The S&P financial data guidelines are given in Appendix 8. The pre-tax coverage for the telephone companies is strong. Conversely, the pre-tax interest coverage for the three cable companies is very low as shown on the second page of Appendix 7.

25. Finally, the average return on common equity for the seven RHCs is 13.5 percent over the 1988-92 period. Over the same period, the average return for the smaller independent telephone companies averaged 16.1 percent. This result is consistent with the view that smaller companies tend to have a higher cost of common equity capital than do larger companies. The S&P Industrials have an average return of 12.9 percent over the 1988-92

period and none of the three cable companies was profitable over the 1988-92 period.

26. These results document that cable television industry companies are significantly riskier than the telephone industry companies or the S&P Industrials. The seven RHCs have an average Value Line beta of 0.86, and the S&P Industrials have a beta approximately equal to 1.0. The three cable companies have an average beta of 1.57. The much higher risk assigned by the market to the cable companies versus the seven RHCs is due:

- In part to the cable companies' relatively small size vis-a-vis the seven RHCs;
- In part to the greater financial leverage of the cable companies; and
- In part to the greater business risk faced by the cable television industry.

27. The effect of the size of the regulated entity on the cost of capital merits further consideration. The cable industry probably will be regulated primarily at the individual system level much the same way telephone companies are regulated by service area. The operating companies of the RHCs tend to serve entire states (or to not service at most relatively small parts of